The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

WINTER 2005 ISSUE 37

Jobs Act Gives Partial Fix to Double Tax on Attorneys' Fees

by Robert W. Wood, Esq.

Double taxation of attorneys' fees arises in a majority of circuit courts because a plaintiff generally must include in income any gross recovery without netting legal fees against the recovery.

The plaintiff can deduct the attorneys' fees, but usually only to the extent the fees exceed 2 percent of adjusted gross income, and even then, subject to limits and to the dreaded alternative minimum tax. In some cases, successful plaintiffs have *lost* money because of the tax bite.

Jobs Act Provision

The American Jobs Creation Act of 2004 (P.L. 108-357) (Jobs Act) allows an above-the-line deduction for amounts attributable to attorney fees and costs received by individuals for claims of unlawful discrimination or claims against the government under the False Claims Act.

The Jobs Act identifies the types of qualifying "unlawful discrimination" by referencing a long list of laws that provide for employment claims. Most federal employment statutes are enumerated.

The Jobs Act also includes a catchall category. Under this category, an above-the-line deduction for attorney fees is allowed for actions relying on any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law that provides "for the enforcement of civil rights" or regulation of "any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law."

How Much Falls Within the Catchall Category?

Federal False Claims Act cases are now entitled to attorney fee relief. However, is the catchall category broad enough to encompass claims under state counterparts to the False Claims Act? I don't see how.

Indeed, this is merely a catchall employment provision and it seems that other claims would not fall within it.

Defamation claims also are not covered. If I am defamed and successfully bring an action through a contingent fee lawyer, I will suffer the same kind of attorney fee tax problems that taxpayers have been dealing with for years. However, defamation might be covered if it occurs within the context of employment. This suggests one set of rules if I am defamed outside of the employment context and another if I am defamed by my employer.

Similarly, if a false imprisonment case occurs in the context of employment, then there might be tax relief for attorney fees. Conversely, if the false imprisonment occurs outside of the context of employment, there would be no tax relief unless perhaps a civil rights claim is made, too.

Perhaps if I suffer physical injuries in the false imprisonment, I might try to obviate some or all of the attorney fee problem in this latter case by excluding the gross recovery from income as allowed for amounts received as compensation for physical injuries under IRC Sec. 104. Yet, the IRS has given very little guidance on the scope of Sec. 104 as amended in 1996. The IRS requires observable bodily harm under Sec. 104.

Other causes of action excluded from the list are negligent and intentional infliction of emotional distress cases. As with the defamation example, emotional distress claims would seem to qualify for attorney fee tax relief only if they occur in the employment context. The IRS could seek to allocate attorneys' fees among various claims.

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Section ACTION

Business Valuation

by Ted D. Israel, CPA

The equity risk premium is the incremental return that equities offer over bonds. It is an indispensable component of discount rates computed under the capital asset pricing model or the buildup method.

It is easy to find: Ibbotson Associates prints it inside the back cover of the *Valuation Edition* of *Stocks, Bonds, Bills and Inflation*. The *2004 Yearbook* lists it at 7.2 percent for the period 1926 through 2003.

There is an increasing group of researchers, authors, and experts that say that 7.2 percent is too high. Roger Grabowski of Standard & Poor's has published a few papers on the subject and has spoken on the topic at several conferences.

Likewise, representatives from Ibbotson are saying the traditional measure is too high. Also, in the November 2003 issue of *Business Valuation Update*, Shannon Pratt wrote, "I am now convinced that the long-term arithmetic average general equity risk premium is too high … Therefore, I would advise practitioners … to make at least the 1.25 percentage point (downward) adjustment …."

The cause of this sea change is that some thought leaders have decided that looking at the arithmetic mean equity risk premia of stocks over bonds for a 77-year period is flawed. Periods are included where key economic conditions, including interest rates, taxes, and inflation, do not match today's market.

The argument is supported by many fund managers and analysts who have adopted lower equity risk premia. Call me simple, but I kind of like that long trend line.

Ted D. Israel, CPA, ABV, CVA is the Business Valuation Section chair.

Economic Damages

by Lynn Carl Jones, CPA

Investigations into the insurance brokerage industry continue, with particular focus on payments from insurers to brokers—known as contingent commissions—for steering business to particular insurers. California Attorney General Bill Lockyer's investigation focuses on bid rigging and other anticompetitive conduct.

If the contingent commission arrangement is determined to be a violation, how should damages be measured?

The insureds are those businesses that paid insurance brokers to find and obtain the best value in insurance products to meet their insurance needs. The insureds, as buyers of insurance products, are the businesses most directly damaged from this broker misconduct.

The process of economic damages measurement consists of: 1) identifying the economic events in play, 2) classifying events as helping or harming specific parties or groups, 3) measuring economic harm net of any offsetting benefits to the damaged party, distributed over time, 4) eliminating economic harm or offsetting benefit that is not covered by the underlying legal action, 5) determining what is legally recoverable, and 6) summarizing the net harm.

If brokerage firms with market power fail to act in the best interests of buyers by taking payments from sellers to recommend sellers' products, what economic events occur?

Diminished competition creates higher prices for insurance products, with the insurers realizing increased revenue and increased costs with the payments to brokers. The higher prices, coupled with contingent commissions, increase profits to the brokerage but also its costs for sales personnel receiving incentive compensation. Buyers may get less insurance coverage than they would otherwise, resulting in greater casualty loss amounts absorbed by the buyer.

Ultimately, the buyer pays more for the same, or less, coverage.

What events would an economic damages expert measure? Measurement of the increased cost to the damaged parties (buyers) would flow from the separate determination of the amount of price increase and the casualty-loss cost of lower coverage, followed by an apportionment to individual insurance products.

The amount of increased cost could be determined statewide or for individual buyers. Such an undertaking is not particularly complex, as it draws only on well-established economic and accounting principles, incorporating quantitative methods in the process.

Lynn Carl Jones, CPA, CFE is the Economic Damages Section chair and managing principal of Jones & Co. in Los Angeles.

Family Law

by Leslie O. Dawson, CPA

Collaborative practice is an option for divorcing couples wanting to avoid court. It is based on the theory that if two parties can work out their own agreement, they are more likely to live by it.

Collaborative practitioners also maintain that allowing parties to negotiate their own terms opens up ideas unavailable in court and is generally a less caustic process than divorcing through the court system.

The basic collaborative practice team consists of the two parties and their attorneys. No judge, mediator, or arbitrator is present. All parties to a collaborative case sign an agreement that states they will commit to the process and openly share all documents and information.

This process assumes a mutually agreed-upon solution is in each party's best interest. Under the model, the attorneys act more as advisors and allow the clients to speak for themselves.

An important aspect of the collaborative agreement is that if the case drops out of collaborative law, all of the professionals involved have to

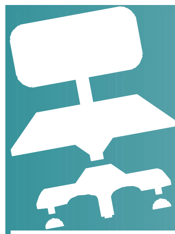
withdraw and the parties must start their case from scratch with new professionals. This provides a certain amount of incentive for parties to stick with the process once they have signed on.

So what does this have to do with CPAs? The parties still may require a variety of services ranging from projected cash flow analysis and financial planning to traditional family law accounting services, such as tracing, business valuation, stock option analysis, and calculation of income for support.

A collaborative law case can be expensive, depending on the number of professionals (counselors, evaluators, etc.) and the time required to complete the process. In addition, it cannot be used in all cases.

Collaborative law provides divorcing couples and their families with another alternative to the often drawn out and potentially more expensive litigation process. For more information, visit *www.collaborativepractice.com* or contact your local collaborative practice group.

Leslie O. Dawson, CPA is Family Law Section chair and a partner in Glenn & Dawson LLP in Walnut Creek.



Message from the Chair

by Andy Mintzer, CPA

The Litigation Sections Steering Committee is following the development of several AICPA initiatives, including the AICPA Statement on Standards for Valuation Services Exposure Draft.

The Steering Committee is reviewing the draft and will provide feedback to the AICPA. All business valuation practitioners should check the AICPA's website for the exposure draft.

The AICPA also is considering developing a definition of forensic accounting, which has different meanings to different people depending on the context. The Steering Committee is monitoring this and will provide input to the AICPA as necessary.

Every Litigation Sections membership comes with membership in one section of your choice. I encourage all Litigation Sections members to support the individual sections and to participate by attending your section's next meeting.

If you have not been to a section meeting recently you have missed hearing about current developments and trends.

Encourage others in your office to join. Associate memberships are available to colleagues and other professionals who are not CPAs.

All the information needed to join is at *www.calcpa.org/members/litsections/description.htm*. As our membership grows, so does our power and ability to offer expanded program offerings.

I urge everyone to participate in leading your sections—attend the meetings, volunteer to help develop or market a program, or make a presentation. There are plenty of involvement opportunities—make it a priority for the new year.

I hope 2005 is a prosperous, healthy, and happy year for you and your family.

Andy Mintzer, CPA, CFE is a sole practitioner based in Santa Monica.

Fraud

by Ramón Machado, CPA

In November, the Public Company Accounting Oversight Board (PCAOB) sought the advice of its Standing Advisory Group on ways to improve quality control over corporate audits, including possible auditing and related professional practice standards.

Among the topics under consideration is a proposed standard requiring the detection and reporting of violations of professional standards or other types of wrongdoing during an audit.

The PCAOB staff asked for guidance on how to best develop "mechanisms that encourage 'whistle-blowing'" as part of a registered accounting firm's quality control system. This would ensure that violations of professional standards, a firm's stated values or code of conduct, and applicable laws and regulations are detected, reported, and corrected on a timely basis.

To accomplish this, registered firms would establish appropriate policies and procedures to encourage whistleblowing and address complaints and allegations originating from within or from outside the audit firm by engagement team members, other firm personnel, clients, or other parties.

The noted features of a quality control system that will encourage the appropriate reporting of violations might include:

1) Clear communication from firm leadership to all personnel regarding the methods available for reporting complaints or allegations, including the provision of anonymity or confidentiality if desired by the complainant,

2) A policy that retribution or sanctions against complainants will not be tolerated,

3) Thorough investigation of complaints and allegations by an appropriate individual with sufficient competence and authority who is independent, and

4) Appropriate action by the firm in response to the investigation's findings.

Although in the developmental stages, the possibility of such a standard is being watched closely by auditors and attorneys.

Ramón Machado, JD, CPA, CFE is a past treasurer of the Fraud Section and founder of Machado & Co. in Orange County.

Keepin' It Legal

Iredale: Where is the Good Will in Goodwill?

by Bernard N. Wolf, Esq.

Goodwill is one of the biggest misnomers in family law practice. Rarely does a community property issue so pit spouse against spouse, lawyer against lawyer, and—you guessed it—accountant against accountant. The sides are zealously demarcated.

For the professional spouse, goodwill is merely the present ability to keep working hard into the future, and hopefully to be paid for that work. Goodwill has no bankable worth. Moreover, if spousal support is at issue, a goodwill calculation based on present valuation of the professional's ongoing stream of income is a double dip at best, and a triple dip or more if the lump sum is not tax-effected.

For the professional's spouse, goodwill is a fundamental recognition of the time, energy, and skill that both parties devoted to enable the professional to attain exemplary status in his or her profession. These efforts are just as worthy of financial recognition as if both parties had worked hard to purchase something more tangible.

If spousal support is not at issue, then goodwill is the recognition of a professional's enhanced earning capacity deserving of equitable partition.

Valuation of Spousal Interests

An especially contentious collision spot between these two legitimate points of view occurs in the valuation of a spouse's interest in a large law firm (or accounting firm, for that matter).

In re Marriage of Iredale and Cates (2004) 121 Cal.App.4th 321 (*Iredale*) is one of the first cases to confront the thorny questions that arise in this setting.

The decision has engendered considerable debate in family law circles over the elusive legal rules that seem to arise from the case.

Yet, the overriding conclusion that I believe must be drawn from *Iredale*—and from much of the legal decisions on professional goodwill—is that the outcome is highly fact-sensitive.

At first blush this conclusion might appear ironic, because a fundamental premise of our community property system is that we characterize property through consistent rules. Nevertheless, professional goodwill valuations in California appear particularly susceptible to individualized judicial assessments.

The results seem more like what we might expect in states with equitable distribution methodologies, where judges exercise wide latitude and tailor their property rulings to fit the facts.

Above all, it was fairness, rather than any immutable legal doctrine, that determined the result in *Iredale* both at trial and before the Court of Appeal. A summary of the parties' backgrounds bears out this conclusion.

Iredale Background

The professional spouse (wife) is a highly educated, talented, and accomplished tax lawyer, who attended Ivy League schools. Her former husband, who pursued goodwill claims against her firm, also is a highly educated, talented, and accomplished tax lawyer, who attended Ivy League schools.

The major difference between them is that the wife is a .00781 partner in a very large and prestigious law firm, whereas the husband has chosen to work part time with the Los Angeles branch of a boutique Washington, D.C. law firm, as well as devoting his skills to investment portfolio management.

This posture in *Iredale* hardly cried out for the seven figure financial claim that the husband made against the wife's fractional, intangible, and potentially ephemeral law firm interest.

After presiding over a lengthy proceeding that spanned 20 volumes of reporters' transcripts, the trial judge, as the finder of ultimate facts, issued a detailed Statement of Decision that largely favored the wife's position.

Under the traditional substantial evidence and abuse of discretion standards of appellate review, the Court of Appeal gave significant deference to these findings.

I certainly could envision a very different result with a different record. I would not hesitate to distinguish *Iredale* on the facts if I thought equity compelled a sizeable goodwill assessment in a particular instance.

Furthermore, I would expect the appellate court to affirm a trial judge's decision that deviated from *Iredale*, assuming that a supporting Statement of Decision was in place.

Effect of Partnership Agreements

Still, there are many legal issues in *Iredale* that deserve consideration. One of these is the effect of a partnership agreement that specifies the financial consequences of withdrawal.

Based on a series of precedents, including *In re Marriage of Fenton* (1982) 134 Cal.App.3d 451 (*Fenton*) and *In re Marriage of Slater* (1979) 100 Cal.App.3d 241 (*Slater*), many practitioners have assumed that a court cannot rely on a contractual withdrawal right to value a professional law practice.

However, prior to *Fenton* and *Slater*, the Supreme Court in *In re Marriage of Fonstein* (1976) 17 Cal.3d 738 (*Fonstein*) expressly sanctioned this approach. *Fonstein* is worth re-reading.

One of the lesser-known aspects of *Fonstein* was the professional spouse's argument that the court should not value his contractual withdrawal right because in his view it was a "… mere expectancy with no present value subject to division …." The Supreme Court flatly rejected this argument. *Iredale* is faithful to *Fonstein*.

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AICPA Alert

by Jeffrey H. Kinrich, CPA

The AICPA's Professional Ethics Executive Committee recently issued two rulings to provide guidance regarding a member's responsibilities when using third-party service providers to provide professional services to clients.

These rulings are Ethics Ruling No. 112 under Rule 102 and Ethics Ruling No. 12 under both Rule 201 and Rule 202.

The rulings require client notification of and consent to the involvement of third parties in the provision of the CPA's professional services and require the CPA to provide adequate oversight of the work performed by the third-party service provider.

The rulings appear to have been inspired by the outsourcing of tax return preparation and related services. However, they are broad enough to apply to business valuation and forensic and litigation services engagements.

The AICPA Forensic and Litigation Services Committee has submitted several questions and concerns about how the letter of the rulings may adversely impact business valuation and forensic and litigation services practitioners. Some of the concerns are:

1) Does the use of an outside data source for a business valuation engagement trigger the notification provision?

2) Is client notification required only if client confidential information is provided to the third party, or whenever a third party performs professional services?

3) How does the CPA provide adequate supervision and ensure that the third party performs with professional competence when the third party is a professional in another field and is applying an area of expertise that the CPA does not possess?

Stay tuned for further developments.

Jeffrey H. Kinrich, CPA, ABV is a managing principal of Analysis Group in Los Angeles.

Attorneys' Fees

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Invasion of privacy claims raise similar issues, as do claims for investment losses and interference with contractual relations, such as contacting prospective employers. If your investment broker has made bad investment decisions on your behalf and you recover from him, presumably you have an attorney fee problem. Conversely, if your employer makes the bad investment decisions for you, and the investment claim is made in the context of your employment litigation, presumably you do not have a problem.

Employment Cases That Miss Out

Some employment lawyers bring employment cases that are not discrimination cases, such as ERISA claims.

ERISA, which applies to pension and welfare benefit cases, pre-empts state law. The Jobs Act enumerates ERISA cases as one of the categories to which the tax relief applies, yet it refers only to ERISA cases under Sec. 510, dealing with discrimination claims, which represent a small fraction of successful ERISA claims.

The more typical ERISA claim is one for benefits, such as for pension or long-term disability. I suppose, and hope, that these other ERISA claims would be entitled to attorney fee tax relief under the catchall category.

Overtime pay is another example. Overtime pay claims generally are not regarded as discrimination claims.

The Jobs Act seems to suggest that any unlawful act that is pursued under the Fair Labor Standards Act (FLSA) should give rise to the above-the-line deduction for attorneys' fees.

However, the IRS may interpret the term "discrimination" narrowly. That would suggest that only true discrimination claims under the FLSA, such as retaliation claims and Equal Pay Act claims, would qualify.

I hope that the catchall category brings many cases under its protection, including overtime, minimum wage, and benefit cases.

Prospective Relief

The Jobs Act provides attorney fee tax relief only for fees and costs paid after the date of enactment, Oct. 22, 2004, with respect to any judgment or settlement occurring after that date. That makes *Banks* and *Banaitis*, the two attorney fee cases pending in the U.S. Supreme Court, of continuing interest. The Supreme Court heard arguments on these cases Nov. 1, 2004.

Last Word

Congress was right to enact the attorneys' fees provision, even if it does not solve everything. Still, I believe an approach that differentiates some claims from others may prompt taxpayers to attempt to pigeonhole their claims within the list of "good" attorney fees—those paid or incurred to pursue federal False Claims Act cases and claims of employment discrimination.

While this is a hugely positive change, the vast majority of lawsuits in the real world have multiple causes of action and a mixture of messy factual details.

What will happen if someone sues for six different causes of action based on a set of facts? Assume that only one of these causes of action is for employment discrimination and that the other claims include defamation arising out of employment. Will the IRS try to allocate the attorney fees?

Robert W. Wood, Esq. practices law with Robert W. Wood, P.C., in San Francisco. He is a certified specialist in taxation and is the author of Taxation of Damage Awards and Settlement Payments (*www.damageawards.org*).

HAPPENINGS

Litigation Sections Meetings

Business Valuation	Thursday, Feb. 3, LAX Thursday, May 12, SFO
Economic Damages	Wednesday, Feb. 2, San Diego Wednesday, April 20, LAX
Family Law	Friday, Feb. 4, LAX Friday, May 13, SFO
Fraud	Tuesday, April 19, LAX

Each section will send individual meeting notices.
Download a copy at *www.calcpa.org/LIT*
or contact Bobbie Nochenson at (818) 546-3502

Education Foundation Courses—(800) 877-5897 or www.educationfoundation.org

Valuation Update and Case Studies for the Experienced Practitioner	Jan. 31, San Diego
Advanced Business Litigation Institute	May 5-6, La Quinta Resort & Club

Keepin' It Legal

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Spousal Percentage Interest

Another issue in *Iredale* is whether the courts should be valuing a spouse's percentage ownership interest in the firm, or his or her individual practice instead. Here, the rule is not so clear.

At trial in *Iredale*, two highly skilled accountants faced off. The husband's accountant appraised the entire firm and divided the result by the wife's fractional share. The wife's accountant relied on the provisions of the partnership agreement. He focused his fall-back analysis on the value of the wife's individual practice, measured under a capitalization of excess earnings approach.

For a variety of reasons the trial court and Court of Appeal favored the approach of the wife's accountant. It is not certain that they would do so in all instances.

Capitalization of Excess Earnings

Finally, the appellate court in *Iredale* grappled with the mechanics of the capitalization of excess earnings methodology.

When ascertaining whether a professional spouse has excess earnings, do we compare her compensation to that of a "… similarly situated professional …" or to the cost of replacing her services with an employee or associate?

The Court of Appeal in *Iredale* left this debate open. Arguments exist to support both points of view, and it remains unclear whether the choice of methodology raises legal issues that need resolution through unbending decisional law or factual issues that may vary with each particular case.

Iredale is open to at least two possibilities: It may be a definitive decision that aides the professional spouse or it may simply be a ruling that is largely fact-based. I favor the latter interpretation and believe that in each individual instance, judges will try to exercise good will when it comes to goodwill.

Bernard N. Wolf, Esq. practices family law and civil appeals. He has argued a number of leading family law cases before the Court of Appeal and California Supreme Court.

Advanced Business Litigation Institute

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- Ethics in Litigation Services and Forensic Accounting
- Wage and Hour Cases
- BV Standards
- Intellectual Property

Plan now to attend!

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California Society Certified Public Accountants

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